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SUBJECT: IMF GIVES ZAMBIA'S ECONOMIC MANAGEMENT HIGH MARKS AGAIN

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¶1. (SBU) Summary: Zambia's Poverty Reduction and Growth Facility program is "on track" and its macroeconomic performance has been good, according to a recent International Monetary Fund assessment team visit. The Zambian Government (GRZ) adequately addressed the team's concerns about fiscal accounts and potentially large carry-overs of unspent funds from year to year, and gave assurances regarding its plans to improve cash management and establish a single treasury. The team observed the slow GRZ movement on private sector development reform, but maintained a "big picture" focus that was largely positive. The IMF team's disregard over both an improved environment for private sector growth and the GRZ's active involvement in the agriculture sector, and its misplaced emphasis on mopping up excess liquidity are disappointing. End summary.

¶2. (U) Introduction: An IMF mission visited Zambia from March 14 to 28, 2007 to complete the fifth review and conduct a sixth review of Zambia's performance under the Poverty Reduction and Growth Facility (PRGF). The mission chief, Francesco Caramazza, briefed donors at the start of the mission and at the mission's end, on March 28. He explained that the report of the previous mission (the start of the fifth review) in October 2006 (Ref B) was never finalized or approved by the Board because of key outstanding fiscal issues, which ultimately were resolved. Highlights of the briefing are provided below.

Overall Picture Good, Concerns Being Addressed

¶3. (SBU) The Fund was pleased with the almost 6 percent real GDP growth in 2006, a result of continued mining sector expansion and a strong construction sector, Caramazza told donors. He did raise concerns at the in-brief over reconciliation of a large discrepancy in the 2006 fiscal accounts. He reported that there was over-financing of about Kwacha 525 billion (USD 125 million) and this was linked to large levels of "carry-over funds" (unspent budget allotments). From 2005 to 2006, carry-over funds amounted to almost Kw 600 billion (USD 143 million), while carry-overs from 2006 to 2007 were possibly as much as Kw 360 billion (USD 86 million). However, during the course of the visit, Ministry of Finance and National Planning (MOFNP) officials provided information and explanations that showed the IMF that the carry-over was lower than originally thought, at Kw 166 billion (USD 40 million).

¶4. (SBU) Caramazza said that large carry-overs were not efficient and reflected cash management difficulties. He said that the MOFNP is well aware of the problems and taking steps to address them, including through establishment of a national treasury and by enacting constitutional changes to the budget cycle, which should make a significant difference. The GRZ maintains many accounts in commercial banks that earn no interest, he noted, and it is essential that these accounts be centralized for better management and accountability. He added that there is a desperate need to strengthen the cash management system and that technical assistance from donors would be welcome.

Inflation Outlook Positive

¶5. (SBU) Caramazza noted that there was a surge in monetary expansion at the end of 2006 that the Bank of Zambia tried hard to absorb. Comment: We understand that the IMF strongly pressured the BOZ to mop up this excess liquidity, although Caramazza did not divulge this to the donors. This impacted the short-term government securities market in two ways. The BOZ's open market operations (OMO) competed directly with the 91-day Treasury bill market, and the BOZ accepted higher interest rates in the drive to absorb liquidity, thereby causing demand for 91-day T-bills to evaporate. Also, OMO has set the benchmark rates that the government securities market is now following, which is the opposite of normal (and good) practice, in which the T-bill is the reference rate. Given its singular monetary policy focus on targeting excess reserves, the IMF is not concerned with these unintended consequences, which will ultimately have a negative impact on government spending, due to higher debt service costs. End Comment.

¶6. (SBU) The IMF believes that the GRZ's goal of 5 percent inflation by the end of 2007 is reachable in the "medium term" (by the end of 2008); Caramazza was not willing to comment specifically about expected results by the end of 2007, because of uncertainty around oil and food prices. Caramazza admitted that the IMF and GRZ need a better understanding of the various factors driving inflation in Zambia, and said that GRZ talk about targeting inflation was "premature."

Budget 2007 -- Some Concerns Over Revenues

¶7. (SBU) Caramazza noted that the 2007 national budget (Ref A) was more expansionary than was indicated by the GRZ's Medium Term Expenditure Framework. The IMF has concerns regarding the revenue projections, he said. He expressed reservations about the way that the GRZ was offering tax incentives, in particular how broadly the

GRZ defined incentives, tax holidays, and its Multi-Facility Economic Zone program. Extensive global experience shows that governments must take measures to ensure that the tax base is not eroded and that sufficient revenues are generated, Caramazza commented, and there are other, better ways to offer incentives to investment. He also credited the Zambia Revenue Authority with better results in collecting Value Added Tax and noted the positive impact of a data base that captured external financing more effectively, thanks to greater information from donors.

Private Sector Development (PSD) Still Lagging

¶8. (SBU) Caramazza had noted in October 2006 that the GRZ had been very slow to implement agreed-upon PSD reform measures (Ref B). He said that GRZ movement on PSD reforms continued to be "slow" and that private sector representatives with whom the mission met raised concerns of GRZ bureaucracy and regulations, the lack of skills in the workforce, and high transport and telecommunications costs. He characterized progress on PSD as "insufficient" and said that the GRZ needed to step up its efforts in this area.

Donor Concerns: Mineral, Agriculture Sectors

¶9. (SBU) Some donors questioned how aggressively the GRZ would seek dialogue with mining companies over new tax and royalty arrangements for mining that were announced in the 2007 budget. They noted that it was hard to get approval for additional budget support in their capitals as long as companies here earned windfall profits from high world copper prices while the GRZ received very little from them in terms of direct revenue. Caramazza reminded donors that the new provisions did not apply to existing contractual commitments, and that given the contributions of the mining sector to the economy and the sector's turnaround in recent years thanks to the new investment inflows, the GRZ should continue to respect contracts. He noted that the largest tax contributor, Mopani Copper Mine, already paid USD 75 million in taxes to the GRZ. He said that some of the mining companies had indicated a willingness to enter into negotiations on their contract terms, but the GRZ had not yet approached them.

¶10. (SBU) When asked about the distorting effect of announced export

bans on maize, Caramazza said that the GRZ told the mission that it wasn't actually banning exports and had already approved the export of 40,000 tons of maize, and that it would be monitoring the situation closely and considering further exports. With respect to a question of (overpriced) maize purchases by the government's Food Reserve Agency (FRA), he said that the GRZ maintains that it will end budget support to the FRA in 2008, at which point the FRA will have to become self-financing. He said that the IMF mission had not discussed fertilizer subsidies with the GRZ.

What's Next?

¶11. (SBU) Due to the delay in completing the fifth review, the PRGF timeframe will be extended by three months. PRGF completion will be in September 2007, rather than June 2007. The IMF and GRZ are discussing two possible options for what comes next: one is another PRGF with a lesser amount of financing; the other is a Public Support Instrument, which involves similar reviews of economic performance, but without the loan facility.

Comment

¶12. (SBU) The IMF team's apparent disregard over lack of progress in PSD reforms and the GRZ's meddling with the agricultural market is disappointing, but it was clear that the team members consider these issues to be outside of their scope of influence. Similarly, the IMF's insistence on the BOZ's addressing excess liquidity regardless of other costs is unfortunately myopic. End comment.

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